Four Lessons from Toys R Us and Puerto Rico's Defaults

The defaults by Toys R Us and Puerto Rico were remarkably similar, even though corporate debt and sovereign debt are quite different. This article highlights three lessons that can be taken from both and one lesson that highlights a key difference between corporate and sovereign debt.

Deteriorating Slowly but Defaulting Suddenly

Both Toys R Us and Puerto Rico followed Ernest Hemingway's description of going bankrupt "gradually, then suddenly." For years both had limped along in financial distress, but investors continued to buy their debt. There's a false comfort in the non-default of stressed borrowers; investors can start to assume that as default didn't happen previously, it is unlikely to occur in the near term. The sudden drop off in bond prices for these two cases showed that close to the end few saw the status quo changing.

For Toy R Us, it followed the standard final steps of a retailer heading towards bankruptcy. Trade insurers pulled back, causing suppliers to demand cash on delivery. Once a few suppliers had taken these steps, the rest quickly followed fearing they would suffer substantial losses if they didn't change their terms of trade as well. As Toys R Us had insufficient liquidity to cover the new terms of trade it quickly became a bankruptcy candidate. Once it became known that bankruptcy advisers had been hired the rapid spiral to bankruptcy was all but completed.

For Puerto Rico, it had been a long term, high yield issuer before the first major shock came in June 2015. When the then governor said that the territory couldn't pay its debts the bonds immediately dropped sharply but then only drifted a little lower over the next two years. The second major shock was Hurricane Maria. Much of the island's infrastructure has been destroyed, which removes most of the revenue base and substantially increases the spending requirements. After issuing 21-year bonds in 2014, a 10-20% recovery on general obligation debt is now on the cards.

The Implications of Lending Without Covenants

The reason both situations were able to deteriorate slowly without earlier intervention was the lack of covenants. In normal times sub-investment grade corporate borrowers would be subject to covenants, but recent years have been anything but normal with meaningful covenants now a rarity. Had solid covenants been in place the increasing leverage would have triggered a review event or a default long ago, giving lenders the opportunity to force change.

The lack of covenants also allowed debt types to proliferate. Toys R Us has a complicated capital structure with senior and junior debt, parent and operating company debt as well as secured property debt. The bankruptcy has added debtor in possession finance to that mix. The lack of covenants allowed Toys R Us to forestall bankruptcy by issuing new debt wherever it could, increasing total leverage and subordinating existing lenders. A standard covenant package would have restricted the business to a standard sub-investment grade capital structure, which limits debt types to senior loans and subordinated bonds.

Whilst sovereigns rarely have covenants, the lack of covenants has led to the same outcome for Puerto Rico. It has debt owed against general obligation revenue, sales tax, multiple types of infrastructure and a grab bag of other revenue sources. Whilst technically not debt, the underfunded pension obligations are effectively debt which is likely to receive preferential treatment as was the case in Detroit's bankruptcy. The majority of the hurricane aid from the Federal Government is expected to come as loans that take priority over the existing debt, similar to a debtor in possession facility. In both cases the lack of covenants means there's an unpredictable fight over the order of priority which will only benefit the lawyers.

Downward Spirals are Hard to Reverse

When a borrower is highly indebted and desperate to avoid bankruptcy it often cuts back spending wherever it can to preserve cashflow for debt repayments. For Toys R Us, it desperately needed to be investing in its stores and marketing to take on key competitors including Amazon. Whilst the company generated substantial EBIT, the interest bill on its huge debt pile left it cashflow negative. Bankruptcy provides the company an opportunity to cut the interest bill, close unprofitable outlets, refresh the fit-out at remaining stores, improve staffing and negotiate better supply agreements now that the threat of non-payment is removed.

For Puerto Rico, its relative poverty led to long term population decline as many of the most talented people migrated to the wealthier US mainland. For governments, higher taxes and cut backs in services encourage those who can leave to do so, with those who can't leave often the ones most dependent upon government services. The growing debt and pension obligations fall onto a shrinking base of taxpayers exacerbating the problem. President Trump's proclamation that the debt needs to be "wiped out" isn't far from what happened in Detroit's bankruptcy, a city that had similar issues as Puerto Rico.

Governments Can Change the Rules Retrospectively on Sovereign Debt

One advantage of corporate debt is that companies don't get to walk away from their debts without handing over their assets. Buyers of government debt often forget this advantage. Sovereign control means it is rare for a government to hand over assets to creditors after defaulting. National governments can declare debts void or print money to pay-off the debt if it is denominated in the local currency. State and local governments don't have this ability, but history has shown that institutional lenders are given the lowest priority for payment. The claims of local residents (for ongoing services and no increases in taxation) and pensioners are prioritised.

In the case of Puerto Rico some bondholders took comfort from the legislation blocking default by US states and territories. This was crazy logic as it assumed taxes could be increased infinitely to ensure their debts would be paid. As discussed earlier excessive taxation leads to depopulation, with the best taxpayers leaving first. Regardless of the law, if a debt is unsustainable it will eventually go unpaid.

To assist Puerto Rico in its default, the US government passed radical new legislation. In the first instance it blocks lawsuits against the territory making debts unenforceable. A judge has been appointed with substantial powers to cancel or reduce debt. Rule of law doesn't last long when a group of faceless hedge funds lines up against a territory of impoverished citizens.

Conclusion

The defaults of Toys R Us and Puerto Rico had long been coming, but the rapid end surprised many. This is a reminder to regularly monitor credit investments and either avoid or sell out of deteriorating credits when prices are good. The lack of covenants allowed leverage to increase unchecked and new types of debt to proliferate, which will result in lower recovery rates and longer restructuring processes. Both defaulters were caught in downward spirals, where the immediate debt servicing needs trumped long term investments and maintenance. Lastly, Puerto Rico is yet another reminder that sovereign debt is subject to retrospective changes that can short-change lenders.

Whilst none of these lessons are new, all of them are being ignored in credit markets. Covenant light lending is more common today than it was before the last financial crisis. Governments with escalating debt loads and no plans to balance their budgets easily attract funding. These prevailing attitudes point to another credit crunch on the horizon with more protracted restructurings and lower recoveries than seen previously.

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